March 2021

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

Rising restrictions to combat a resurgence in the spread of COVID-19 towards the end of 2020 slowed the global recovery but did not derail it. While the restrictions put in place will also affect Q1 growth, 2021 is shaping up as a strong year. A reduction in COVID-19 cases, vaccines being rolled out, loose monetary policy settings and, particularly in the US, continuing fiscal support will all support growth. We have revised up our US forecasts significantly (from 5.0% to 6.0% in 2021) in expectation of a further fiscal stimulus package of around $1.9 trillion. Bond yields have risen globally, partly on the back of higher growth and inflation expectations. This has negatively impacted equity markets and also seen some rise in volatility. However, overall, financial conditions still appear accommodative. We expect global GDP growth of 6.2% in 2021 (previously 5.8%) and 4.6% in 2022. With vaccine roll-out still at an early stage in most countries, the risk of another COVID-19 wave cannot be ruled out.

- Bond market yields started rising gradually in Q4 2020 and then surged from mid-February, partly reflecting the roll-out of vaccines and the prospect of larger than expected fiscal stimulus in the US which have raised growth and inflation expectations. US 10 year Treasuries rose to around 1.5% – a level last seen prior to the COVID-19 pandemic. The rise in yields has impacted other **financial markets** – with equity markets declining from recent cycle peaks in mid-February and a spike in the VIX volatility index. Despite this, financial conditions indices have steadily trended higher since mid-October – indicating more accommodative conditions.
- **Commodity markets** have continued to strengthen, having gained momentum since late 2020 on the stronger global economic outlook. The aggregate Refinitiv CoreCommodity CRB Index was at its highest level in late February since mid-2018. Excluding energy (reflecting the weakness in oil demand due to COVID-19 restrictions), the index was at its highest level since September 2014.
- Despite the rise in inflation expectations, and improved growth outlook, we anticipate policy rates remaining low for the next two years, with major **central banks** continuing to provide monetary support via unconventional policy measures, such as asset purchases. In part this reflects the fact that inflation in major economies has been low for a while, the major central banks see some of the price pressures as temporary and, moreover, they would welcome a lift in inflation (even to above target levels in some cases). Markets continue to price stable policy rates for most major central banks for the foreseeable future.
- **Major advanced economy** (AE) growth slowed towards in Q4 2020 (turning negative in the Euro-zone) and into early 2021. With the latest wave of COVID-19 having receded, there has been some reversal of restrictions – mainly in the US and Japan with Europe more mixed (although the UK is planning to remove most restrictions by June). This will support growth heading into Q2. Fiscal support is another positive for the outlook with a further massive US stimulus bill likely to be signed-off soon. We had been assuming $1 trillion but now expect it to be around $1.9 trillion (around 9% of GDP). As a result, we have substantially lifted our US GDP growth forecast for 2021 from 5% to 6%. As vaccinations aren't yet at the level needed to control COVID-19 the spread of the virus remains a risk, although the on-going roll-out of vaccines should eventually provide a more solid underpinning to the recovery. As a result, rapid AE growth is expected as the year unfolds.
- Indicators continue to point to a gradual softening in conditions in **emerging markets** (EMs). The EM Manufacturing PMI eased in February continuing a trend evident since the recent cycle peak in November 2020. This decline was led by China while India was relatively stable. In contrast, the EM services PMI edged a touch higher in February; a decline in the Chinese and Russian services PMI was more than offset by a pickup in India. At China's National People's Congress in early March, Premier Li announced a surprisingly weak 6% growth target for 2021. Although this level is typical of earlier, pre-COVID-19 targets, base effects should push China's growth considerably above this rate in 2021.
- We have revised up global growth forecast for 2021 to 6.2% (was 5.8%) and still expect 4.6% in 2022. The global PMI business surveys have remained above their break even level, although there was a temporary dip in the services PMI before recovering in February. A fall in COVID-19 case numbers is triggering an easing in restrictions in some countries (e.g. US, Japan) or plans to do so (e.g. the UK). The combination of easing restrictions, healthy household balance sheets in the major AEs, and further large scale US fiscal stimulus points to rapid growth over the rest of 2021. Apart from the risk of further COVID-19 waves (at least until community vaccination is widespread), there are other **risks to the outlook**. Rising bond yields can lead to capital flow pressures on EMs and how, and when, governments address the deterioration in public finances will be important to watch.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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In Australia, the economy continues to recover at a rapid pace. The Q4 national accounts showed GDP rising by 3.1% in December to be 1.1% below its pre-COVID level in Q4 2019. The better-than-expected outcome for GDP and ongoing strength in the NAB survey and other timely indicators, is consistent with the strong labour market recovery – with unemployment falling to 6.4% in January. Incorporating this stronger starting point into NAB's forecasts, we now forecast GDP to reach its pre-virus level in Q1 2021, seeing year-average growth of 4.6% in 2021 and 2.5% in 2022. For the labour market, we now see unemployment falling to 5.3% by end 2022 - just above its pre-virus level. While we forecast the economy to recover its pre-virus level of activity in Q1, spare capacity will remain which will take at least until 2022 to work through. Accounting for the usual lags between activity, the labour market and ultimately inflation, this suggests that inflation could return to the target in 2024. This outlook warrants the RBA leaving the cash rate unchanged to at least 2024 and extending QE by another $100bn late this year. That said, it also supports our view that the RBA should limit YCC to the April 2024 bond, where the RBA will have difficulty credibly committing to an unchanged cash rate past this date. We think the RBA has until mid year to decide on YCC, in the meantime our focus is on the impact of the end of the JobKeeper wage subsidy and reduction in the JobSeeker payment, which could well see a slowing in momentum in the labour market.

- **The cash rate is likely to remain unchanged for the next few years, although YCC will need to end**. Even on our outlook for a rapid recovery, spare capacity in the economy will take time to be eroded. Our estimates suggest, at best, GDP could reach potential in 2022, putting at-target inflation on the table for 2024. However, it's likely inflation takes longer to reach the 2-3% band, particularly as we think the NAIRU in the medium term is around 4.5%. As such, we forecast the cash rate to stay unchanged until at least 2024 and the RBA to extend QE by $100bn for a 3rd successive round later this year. That said, as we outlined in mid-January, we expect the RBA to end the YCC program by halting purchases under the program at the April 24 bond, as extending YCC and committing to a 3-year yield of 0.1% beyond mid 2024 becomes less credible for the RBA. This is likely to be announced around the middle of 2021.
- **The unemployment rate should continue trending down,** where we forecast an unemployment rate of 5.3% by the end of 2022, just above the 5.2% recorded pre-virus. While this is a very quick recovery in unemployment, relative to previous downturns, it is likely that the goal of full employment remains a while away. Our model estimate suggested NAIRU was 4.9%, but history suggests NAIRU is likely to be much lower – we think it is likely around 4.5%. As such, wages growth will remain sluggish for some time, given the significant degree of spare capacity remaining in the labour market. Consequently wage growth is expected to lift only gradually from a very weak starting point.
- **Consumer spending recorded another strong rebound in Q4.** Household consumption rose by a strong 4.3% in Q4, where Victorian spending jumped 10% following the end of its strict lockdown. Despite the strong increase, household consumption remains 2.7% below pre-COVID levels, with ongoing impacts to some services such as travel. More recent data – both offical retail sales and the NAB Cashless Retail Sales index - suggests that goods consumption has held up in early 2021 – though the pace of growth has slowed.
- **The NAB Business Survey shows conditions and confidence at multi-year highs in February.** Capacity utilisation rose to an above average level while reported capex continued to strenthen. Encouragingly, the survey continues to point to a robust recovery in the business sector, despite some tapering of government support in late 2020. This will be important going forward given business investment has weakened in recent years falling to a relatively low share of GDP. The Q4 accounts saw some greenshoots with spending on equipment rising strongly (likely supported by the Government's isntant asset write-off). Ongoing strength in confidence and high rates of capacity utilisation will likely be a pre-condition if business investment is to continue rising.
- **Housing market activity is taking off.** Dwelling prices rose by a large 2.0% in the month of February – as measured by the CoreLogic 8-capital city dwelling price index – to be 2.6% higher over the year. The sharp rise was driven by prices in Sydney, Melbourne and Hobart, although all capital cities recorded strong gains. Regional house prices continue to grow strongly too, marking a 2.1% rise in the month. Likewise, lending data shows both owner-occupier and investor loan approvals jumped in January, up 11 and 9% respectively. Owner-occupier loans are at record highs and 52% higher than a year ago. This sharp turnaround reflects the impact of lower rates, HomeBuilder grants, stamp duty discounts and the solid rebound in the economy. NAB forecasts dwelling prices will rise 7.9% over 2021 and of 6% over 2022
- **Key fiscal support is significantly tapering at the end of March.** We highlight the risk from the pull back in fiscal support – most notably the federal government's JobKeeper wage subsidy, which stops at the end of March. Our forecasts assume only a small drag from the removal of these programs, such that employment and consumer spending continue to rise, albeit at a slower pace. However, the clear risk is that once key supports are removed, the economic recovery falters.
- **We expect the AUD/USD to end 2021 at 0.83 USD** before declining to 0.80 USD by the end of 2022. This largely reflects Australia's economic outperformance, the improvement in risk sentiment and the global recovery getting underway, particularly amid positive developments in the race to deploy a COVID-19 vaccine.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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